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By William K.S. Wang[*]

The House of Representatives in May 2019 passed a bill, the ''Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019,'' which would generally impose a 10-year mandatory distribution period for ***non-spousal*** beneficiaries of §401(k)/IRA's, both Roth and traditional (non-Roth).[1] This 10-year distribution for ***traditional*** §401(k)/IRA's may ***decrease*** government revenue.

A traditional §401(k)/IRA is a ***joint venture*** with the government and may be a positive-sum game. This is easier to understand by ***initially*** assuming a constant flat income tax of, say, 30%. Perpetually, the beneficiary owns 70%, and the government owns 30%. Of every dollar ever withdrawn, she gets 70 cents, and the government receives 30 cents.

Distributions from the traditional §401(k)/IRA are not subject to ''tax'' in the conventional sense. Instead, they are a partial liquidation of the joint venture with each party taking the share ***already*** owned.

Because the beneficiary's 70% interest is never subject to tax, including on withdrawals, the 70% interest is like a ''Roth'' within the traditional §401(k)/IRA. The tax exemption of this ''Roth'' within is the only tax benefit of the traditional §401(k)/IRA and ***may*** represent a revenue loss to the government.

From the required distribution, the government's revenue gain, ***if any***, is ***not*** the so-called ''tax'' on the distribution, but any additional tax from the beneficiary who loses the tax exemption of her ''Roth'' within the traditional §401(k)/IRA and ***chooses*** to reinvest her after-''tax'' distribution in securities (or engage in trades in those securities) that generate taxable income.

The government gains ***no*** tax revenue as a result of the distribution if the recipient employs the after-''tax'' amount in various ways, including (1) spending it, rather than reinvesting it; (2) reinvesting in her state's tax-exempt municipal bonds; or (3) reinvesting in non-dividend paying stock and holding until death's stepped-up basis.

The 10-year compulsory drawdown may be imprudent for the government. ***Both*** owners gain from the traditional §401(k)/IRA's appreciation in value. When the government withdraws part of its interest in the joint venture and spends the so-called ''revenue,'' the government ''dissaves'' and ***loses any future gains*** on the amount ''dissaved.''

The government somewhat resembles the taxpayer who liquidates and spends part of her traditional §401(k)/IRA. Commentators and the government consider imprudent ***pre***-retirement ***employee*** withdrawals.

If the government insists on ''dissaving'' for expenditures, instead of mandating the 10-year distribution the government could borrow to spend. Such debt would allow the government to retain its interest in the §401(k)/IRA ***jointly owned*** with the non-spousal beneficiary. If, as is likely, the §401(k)/IRA generates a higher long-term return than the government's cost of borrowing, the government will benefit, just as a homeowner profits if her home appreciates at a faster pace than her mortgage rate.

With no obligatory 10-year distribution, the appreciation in the government's interest in the traditional §401(k)/IRA may exceed any tax revenue lost from a beneficiary who would have elected to reinvest her after-''tax'' distribution in a manner that produced taxable income.

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[1] H.R. 1994.

All section references are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations thereunder, unless otherwise indicated.

The above analysis assumes a constant flat income tax. In fact, a non-spousal beneficiary will have marginal tax brackets (the tax rate that applies to the next dollar of income) that vary over her lifetime. Typically, an individual has income lower in his or her early career, higher in late career, and lower in retirement. During the 10-year mandatory distribution, the beneficiary may be in a tax bracket higher or lower than later in life. If the inherited §401(k)/IRA is large, a 10-year required distribution may thrust the beneficiary into a higher tax bracket. In addition, the 10-year term precludes timing increased withdrawals during later periods of reduced income.

Most-likely, the 10-year required distribution will result in beneficiaries being in higher tax brackets than if they were able to stretch distributions over their lifetimes.

In sum, the net revenue effect of the 10-year mandatory distribution is a result of two countervailing factors:

(1) the government's ***loss*** of future profits from its joint ventures with the beneficiaries, possibly with the government borrowing to retain its interests, ***versus***

(2) the government's revenue ***gain*** from

(a) any tax on beneficiaries who ***choose*** to reinvest their after-"tax" mandatory distributions in securities (or engage in transactions in those securities) in a way that produces taxable income, ***plus***

(b) the increased tax on beneficiaries who, during the 10-year term, are in higher tax brackets than with a lifetime distribution period.

The net result is unclear, especially with the difficulty of predicting the future investment performance of the joint ventures. The government may be worse off with the 10-year compulsory distribution and should not require it.

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